

the Southwest ECONOMY

FEDERAL RESERVE BANK OF DALLAS

ISSUE 1 – 1996

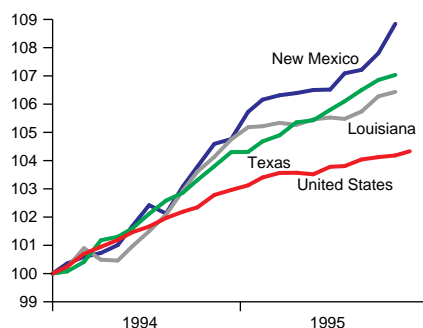
Southwest Expansion To Continue In 1996

“The Southwest economy is likely to see its 10th consecutive year of economic expansion.”

The Southwest economy's expansion during 1995 nearly matched its historical average and remained strong relative to the national average (*Chart 1*). All three states in the region—Louisiana, New Mexico and Texas—benefited from strength in the construction sector. Strong growth in the *maquiladora* industries and in exports to countries other than Mexico allowed Texas to avoid the potentially large negative effects of the peso devaluation. The gaming industry remained the key source of activity in the Louisiana economy. New Mexico continued to be propelled forward by expansions in high-tech manufacturing.

Chart 1
Southwest's Employment Grows
Faster than the Nation's

Index, January 1994 = 100



SOURCE OF PRIMARY DATA: Bureau of Labor Statistics.

In 1996, the Southwest economy is likely to see its 10th consecutive year of economic expansion. Sluggish overall growth in the U.S. economy and some tightness in regional labor markets, however, could restrain growth. After growing at an annual rate of 3 percent in 1995,¹ combined nonfarm employment in Louisiana, New Mexico and Texas should slow to about 2.4 percent in 1996. Of the three states, New Mexico is likely to have the fastest rate of growth, followed by Texas and Louisiana.

Southwest Construction Activity Strong in 1995

While the sources of strength varied throughout the region, the construction sector generally was strong in all three states (*Chart 2*). The residential sector benefited from lean inventories at the start of the year and a sharp decline in mortgage rates throughout the year. While nationally the average value of residential construction was lower in the first 10 months of 1995 than in 1994, it was higher by 5.8 percent in New Mexico, 5.3 percent in Texas

I N S I D E

**Tax Reform: Is the Time
Right for a New
Approach?**

**Exchange Rates, Capital
Flows and Monetary
Policy in a Changing
World Economy**

“Although the Mexican pesos’s devaluation hit the border retail industry hard, strength in the maquiladora industry offset much of the blow.”

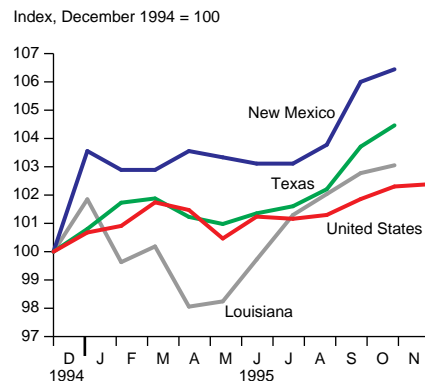
and 1.4 percent in Louisiana. Non-residential contract values also increased, particularly in Louisiana, where the retail sector saw steady growth and a major flood in New Orleans triggered construction activity.

Texas Shakes Off Peso Effects

Texas nonfarm employment slowed from a strong 4.5-percent growth rate in 1994 to a more moderate rate of 3.2 percent in 1995. Employment growth in 1995 was equal to its historical average and was stronger than national growth of 1.4 percent. The strength of the Texas economy in 1995 was somewhat surprising in light of the peso devaluation and ensuing sharp recession in Mexico. Because exports to Mexico represent about 40 percent of Texas exports and Mexican shoppers are responsible for much of the retail activity along the Texas border, events in Mexico can have a significant impact on the Texas economy.

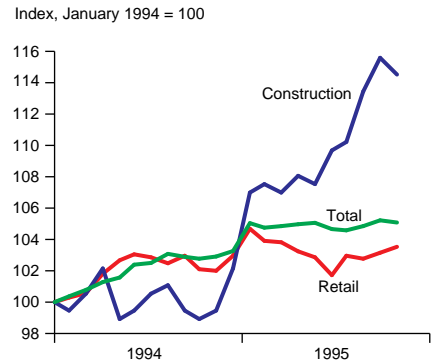
Although the Mexican peso’s devaluation hit the border retail industry hard, strength in the maquiladora industry offset much of the blow. The maquiladora companies on the Mexican side of the border, whose budgets are dollar-denominated but whose costs are in pesos, received a boost

Chart 2
Southwest Construction Employment Shows Robust Growth



SOURCE OF PRIMARY DATA: Bureau of Labor Statistics.

Chart 3
Border Employment Stable in 1995



SOURCE OF PRIMARY DATA: Bureau of Labor Statistics.

from the devaluation. The thriving maquiladora industry resulted in greater warehousing, distribution and manufacturing needs on the Texas side of the border. Federally mandated intrastate trucking deregulation, which began in January 1995, also added some stimulus to the region. The deregulation put downward pressure on trucking rates in the state, stimulating demand for warehouse space along the border and throughout the state. The increased demand for warehouses and other commercial and industrial space led to a surge in construction activity that offset much of the decline in the retail sector (Chart 3).

While the peso devaluation resulted in a significant decline in exports to Mexico, a surge in exports to other countries largely offset the reduction. While exports to Mexico declined at an annual rate of 13.8 percent during the first three quarters of 1995, Texas exports to other countries increased at an annual rate of 23.1 percent, resulting in an overall export gain of 8.4 percent (Chart 4).

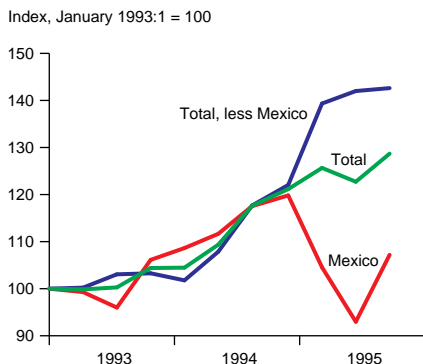
The petrochemical industry has been particularly successful in shifting export markets for its products. While exports of chemical and allied products from Texas to Mexico slowed sharply during the first three quarters of 1995, total exports from this industry surged

44 percent. The value of chemical and allied product exports in the first three quarters of 1995 was \$11.1 billion, which led all other industries and represented 22 percent of the value of total Texas exports.

Electric and electronic equipment manufacturers in Texas were also successful at shifting exports. A worldwide surge in demand for semiconductors and telecommunications equipment allowed Texas manufacturers of these products to compensate for reduced demand from Mexico with increased shipments to countries around the world. Although Mexican exports have been an important source of strength for Texas electric and electronic equipment manufacturers,² employment and exports in this industry accelerated in 1995 despite the reduced demand from Mexico.

The growth in the electronics industry contributed to Texas high-tech industries' overall strength. While the share of high-tech industries in the state is about the same as the national average, Texas' employment growth in the high-tech sector over the past six years has been twice as strong as the nation's.³ Texas' strongest relative performance has been in computer- and telecommunications-related industries such as computer, semiconductor, cellular phone manufac-

Chart 4
Texas Exports Expand in 1995



SOURCE OF PRIMARY DATA: Massachusetts Institute for Social and Economic Research.

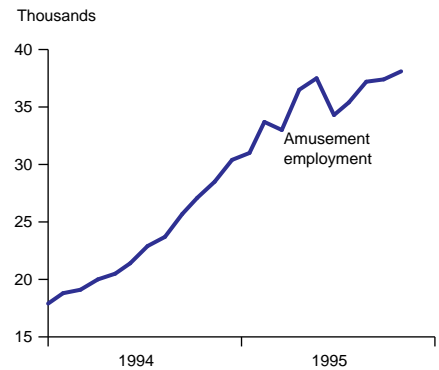
turing and service firms that provide programming and data processing. While the monthly employment data are too aggregated to measure recent growth in the high-tech sectors, anecdotal evidence and movements in broader employment categories suggest that the high-tech sector grew strongly in Texas in 1995.⁴

Gaming Industry Remains The Driver in Louisiana

Employment growth in Louisiana slowed from a strong 5.1-percent rate of growth in 1994 to a more moderate pace of 1.9 percent in 1995. Employment growth in 1995 was just slightly below its historical average rate of 2.1 percent. The gaming industry, despite some setbacks in 1995, remained the major driving force behind growth in the Louisiana economy. After rapid expansion in 1994, the gaming industry slowed in 1995 as two riverboat casinos and one temporary land-based casino in New Orleans closed their doors. Also, plans for a permanent land-based casino in New Orleans were put on hold. Even with these setbacks, however, employment in the amusement industry in Louisiana increased 31.1 percent in 1995 after growing 64.3 percent in 1994 (Chart 5).

The energy industry was also a positive force in the Louisiana economy in 1995. Improvements in offshore drilling techniques and strong expectations about future natural gas consumption resulted in a December-to-December gain of 15.3 percent in the rotary rig count, which indicates oil and gas exploration activity. Employment in oil and gas extraction increased at an annual rate of 2.6 percent through the first 10 months of the year. Increased profit margins and exports for petrochemicals led to continued strong capital expansion in this industry throughout the Texas/Louisiana Gulf Coast region in 1995.

Chart 5
Louisiana Gaming Industry Strong Despite Setbacks



SOURCE OF PRIMARY DATA: Bureau of Labor Statistics.

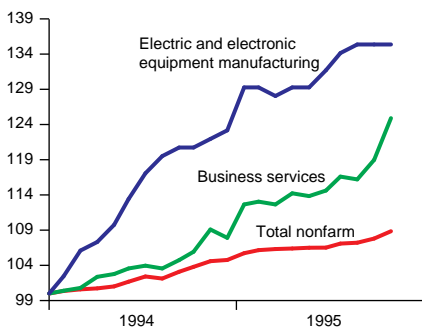
High-Tech Industries Fuel Strong Growth in New Mexico

New Mexico nonfarm employment increased 4.7 percent in 1995, only slightly less than the state's strong 5.1-percent growth rate in 1994. In 1995 and for the fourth consecutive year, New Mexico's growth surpassed its historical average of 3.3 percent. While Texas businesses were concerned about the impact of the peso devaluation in 1995, businesses in New Mexico worried about how downsizing in the defense sector would affect employment at the two national labs, Sandia and Los Alamos. Employment at Los Alamos declined by about 1,000 jobs, while Sandia experienced only slight employment losses.

Job losses at the two national labs have been more than offset by strength in New Mexico's high-tech industries. High-tech firms such as Intel, Motorola, Philips Semiconductor and Intuit have had an important impact on growth in the New Mexican economy. While high-tech jobs represent about 3.1 percent of total U.S. employment, high-tech employment in New Mexico represents about 5.4 percent of total jobs. Announced expansions at many of the large high-tech firms in the state and growth in broad employment cate-

Chart 6
High-Tech Employment
Surges in New Mexico

Index, January 1994 = 100



SOURCE OF PRIMARY DATA: Bureau of Labor Statistics.

gories suggest that the New Mexican high-tech sector grew strongly in 1995. As a rough measure of high-tech growth, 1995 employment increased 12.1 percent in electric and electronic equipment manufacturing and 17.9 percent in business services (*Chart 6*).

Other sources of strength in New Mexico include expansions in bus manufacturing, food processing and retail trade. An important source of weakness in New Mexico in 1995 was a decline in the mining sector. Employment in both mineral mining and oil and gas extraction declined. The devaluation of the Mexican peso also had a negative effect on the New Mexico economy, although total exports and exports to Mexico represent a much smaller share of the economy in New Mexico than in Texas.⁵

Southwest Economy's Growth Likely to Slow in 1996

While growth should remain positive in Louisiana, New Mexico and Texas, a sluggish national economy and other factors may slow the region's growth in 1996. In late 1995, business contacts in Texas reported a significant increase in labor market tightness across a wide range of occupations. The market for skilled workers—such as mechanics, electricians, machinists, engineers and software devel-

opers—remained tight. Contacts also noted that wages were being bid up for accountants and lawyers from top-tier schools. Several contacts also noted difficulty finding lower skilled workers with basic reading, writing, math and communications skills. Slow U.S. growth and the apparent mismatch between the skills of the unemployed and the skills demanded by the growing industries in the state may hinder growth in Texas. Recent movements in the Texas leading index suggest that growth in Texas nonfarm employment will likely slow from 3.2 percent in 1995 to 2.4 percent in 1996.

Reduced construction activity may result in slower growth in the Louisiana economy. Although gaming activity is likely to remain level in 1996, subsiding expectations about its profitability should diminish capital investment. A colder than normal winter would bode well for natural gas producers in the state, who are already benefiting from improved offshore drilling technology.

After growing in excess of 4.5 percent for three consecutive years, nonfarm employment will probably slow somewhat in New Mexico in 1996. Construction activity is likely to slow from the strong pace in 1995, due to a reduction in high-tech capital expansions. Continued declines in defense spending should also be a significant drag on the state.

—Keith R. Phillips

Notes

I wish to thank Loren Scott at Louisiana State University and Andrew Krikelas at the Federal Reserve Bank of Atlanta for helpful discussions about the Louisiana economy and Brian McDonald and Lawrence Waldman at the University of New Mexico for information on the New Mexico economy.

¹ In this article, 1995 employment growth refers to the annualized rate of growth from December 1994 to October 1995, the most recent data available. All data used are seasonally adjusted. The state

employment data are adjusted using the Berger/Phillips two-step technique, and the Texas employment data is benchmarked through March 1994. These employment adjustments are described in the July/August 1993 issue of *Southwest Economy*.

² In Issue 1, 1995, of *Southwest Economy*, Lori Taylor and Rhonda Harris find that the electronics and electric equipment industry is the third most sensitive Texas manufacturing industry to changes in the value of the Mexican peso.

³ For the definition of high-tech industries and a description of their importance to the Texas economy, see D'Ann M. Petersen and Michelle Thomas in "From Crude Oil to Computer Chips," *Southwest Economy*, Issue 6, 1995.

⁴ For example, employment increased at an annual rate of 5.9 percent in electric and electronic equipment manufacturing, 8.7 percent in nonelectrical equipment and computer manufacturing, and 9.8 percent in business services. While each of these employment categories contains some industries that are not classified as high-tech, it is likely that the high-tech industries in these categories are responsible for much of the overall growth. Although the high-tech component of business services is small, anecdotal evidence suggests that high-tech industries are responsible for much of the growth in temporary employment agencies, which is a large share of business services.

⁵ In 1992, total exports as a share of nominal gross state product was 12 percent in Texas and 1.2 percent in New Mexico. Also, 1994 exports to Mexico represented 40 percent of Texas exports and only 17.9 percent of New Mexico exports.

Tax Reform: Is the Time Right for a New Approach?

“The sum the average firm pays to keep track of tax-related information may exceed what it pays in taxes.”

In the eyes of many Americans, our income tax system is overly complex, basically unfair and—in short—fatally flawed. At least half the citizens surveyed in recent public opinion polls would support radical reform.

They have a point. Although length is not necessarily synonymous with complexity, the U.S. income tax code now has more than 700 times as many words as the U.S. Constitution. Furthermore, the costs of complying with the individual income tax code are high and rising (*Chart 1*). Estimates of the compliance costs associated with the corporate income tax are even higher, ranging from about 50 percent to more than 100 percent of the revenue collected. In other words, the sum the average firm pays to keep track of tax-related information may exceed what it pays in taxes.

The complexity of the tax code feeds public suspicion that the tax system is unfair. Many taxpayers would agree with Nobel Prize winning economists Milton Friedman and James Buchanan that much of the system’s complexity results from politicians’ trading tax preferences for campaign contributions.

Economists’ training leads them to focus more on the tax system’s inefficiencies than its complexity and unfairness (though the three problems are closely related). Here too, the U.S. income tax code falls short. A striking example of inefficiency in the income tax code is its unequal treatment of income from different sources. Under current law, wage and interest income is taxed only once—at the individual level. Meanwhile, profits are taxed twice—first at the corporate level then again at the individual level. For profits that are distributed as dividends, the top combined marginal tax rate can exceed 65 percent. This heavy taxation of dividends and capital gains discourages saving and entrepreneurship; it encourages firms to use debt finance rather than equity finance, making them

more vulnerable to economic downturns; it slows economic growth.

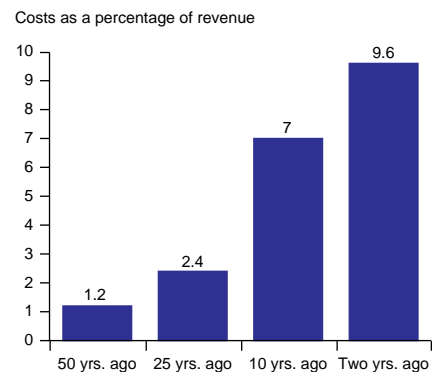
The Consumption Tax

The principal alternative to an income tax is a consumption tax. Consumption taxes encourage saving and investment by deferring taxes on income until that income is spent. They make moot a host of complex issues concerning depreciation schedules and the timing of capital gains. Furthermore, a household’s wealth and well-being are more directly tied to its consumption spending than to its income.

Three alternative versions of the consumption tax have been proposed. Two of the proposals can be described as direct taxes on consumer purchases—the national sales tax and the flat tax. The third proposal, known as the unlimited savings allowance (USA) tax, exploits the principle that income must either be saved or consumed by taxing the difference between income and savings.

Although equivalent in spirit, the proposals differ in important details. Before discussing the likely economic consequences of replacing the income tax with a consumption tax, it may therefore be helpful to review the distinguishing characteristics of the alternative plans.

Chart 1
The Rising Cost of
Complying with U.S. Tax Codes



NOTE: Compliance costs include the resources that the Internal Revenue Service expends in enforcing the tax laws as well as the costs that taxpayers incur in filling out tax forms.

SOURCES: Joel B. Slemrod, as quoted in *Business Week*, January 9, 1995, and James L. Payne, *Costly Returns*, (Lanham, Md.: Institute of Contemporary Studies Press, 1993).

“Once enacted, any of these three proposals would likely have a positive effect on saving and investment.”

The National Sales Tax. Representative Bill Archer (R-Texas) and Senator Richard Lugar (R-Indiana) argue that consumption spending should be taxed directly. A national sales tax on retail purchases would be one such strategy. An equivalent measure would be to impose a tax at each stage of production on the difference between sales revenue and payments made to other businesses for materials, equipment and supplies. Such a sales tax is called a value-added tax, or VAT. Most sales tax proposals would exempt food and medicine to reduce the burden of taxation on the poor. All other goods and services would be taxed. Economists estimate that the sales tax rate would have to be at least 21 percent to raise as much revenue as the current income tax.

An attractive feature of a national sales tax is that even those with illegal sources of income would pay taxes with every purchase. In the same vein, a sales tax is anonymous: no one need know how much money the taxpayer makes or where it comes from. Another advantage is that the sales tax concept is familiar and easy to understand.

The proposal does have drawbacks, however. A 21-percent sales tax levied at the retail level would invite widespread under-the-counter sales. The VAT approach would reduce the incentive to cheat by taking many small bites instead of one large one. However, the costs of complying with a VAT would be extremely burdensome to small businesses. Moreover, because taxes would be hidden in the prices consumers pay rather than transparent as with the sales tax, a VAT could be an invitation to tax increases.

The Flat Tax. Representative Richard Arme (R-Texas) proposes a modified VAT known as the flat tax. Under a VAT, firms pay tax on their sales less the sum of their purchases from other businesses. The flat tax would work in exactly the same way, except each firm's employees would be paid with pre-tax dollars, and employees would

write checks to the government for the taxes due on the wage component of value added. In effect, the flat tax treats each worker as an independent contractor. This difference in the treatment of wages has two important benefits. First, taxes wouldn't be hidden, as they are under a standard VAT. Second, the flat tax approach would allow a certain amount of each individual's wages to be exempted from taxation (\$13,000 for singles, \$26,000 for couples, plus \$5,300 per dependent under the Arme proposal), making it easy to limit the tax burden on the poor.

On the negative side, flat tax opponents claim that people without labor income would pay no tax. The statement is only superficially true: nonwage income would be taxed before it is distributed, at the same rate as wage income.

Representative Arme proposes that the initial tax rate be 20 percent. Most economists think the rate would need to be closer to 23 percent to replace the revenue from the current income tax.

The USA Tax. Senators Sam Nunn (D-Georgia), Pete V. Domenici (R-New Mexico) and Bob Kerrey (D-Nebraska) propose a consumption tax disguised as an income tax. The key difference between the current income tax and their USA tax is that under the USA plan net new saving would be fully deductible from income for tax purposes. Households would continue to report wage, dividend, interest and capital gains income on their tax returns. They would continue to deduct home mortgage interest and charitable contributions. A modest deduction for higher education expenses would be introduced. The value of fringe benefits such as employer-provided health insurance would be included in household taxable income for the first time. Tax rates on personal income would be graduated—rising from 19 percent to 40 percent—while the corporate income tax would be scrapped and replaced with an 11-percent

VAT. Tax rates would be higher than under the other reform proposals, partly because the USA tax would retain more deductions than the other proposals and partly because Social Security benefits, in effect, would be financed from general revenue under the USA plan.

Of the three reform proposals, the USA tax is the only one that uses the tax code to stimulate investment in education as well as in plant and equipment. It is also the only reform proposal that incorporates Social Security taxes.

On the minus side, the USA tax would do little to simplify the tax code. It would continue the current subsidy to home ownership and actually would increase the incentive for home ownership by not counting new home equity loans as taxable dissaving. Additionally, households would be able to accumulate up to \$35,000 in nonmortgage debt without tax liability. Consequently, the USA tax would provide less overall stimulus to saving and investment than the other tax reform proposals reviewed here.

Likely Effects of Switching To a Consumption Tax

Once enacted, any of these three proposals would likely have a positive effect on saving and investment, for two reasons. First, because they are consumption taxes, each proposal defers the taxation of income until the income is spent. Second, each proposal eliminates the current system's punitive taxation of dividends and capital gains. As shown in the right-hand column of Table 1, increased saving and investment will eventually pay off in a higher capital stock, higher real wages and greater consumption. Laurence Kotlikoff of Boston University has estimated that switching to a consumption tax would boost the nation's stock of plant and equipment by nearly 27 percent after 20 years. A 27-percent increase in the capital stock would mean nearly 10-percent increases in real wages

and real output, relative to their level under an income tax.

In the near term—described in the left-hand column of Table 1—greater investment can be achieved only at the expense of consumption. So, in the years immediately following tax reform, consumption would be lower than it would have been under the current system.

On a cautionary note, the prospect of tax reform may have a perverse effect on the economy in the prereform period. Knowing that investment would soon be receiving more favorable tax treatment, people would be likely to spend more on consumption and defer investment in the months before the new tax law takes effect.

The Effects on Interest Rates. The real yield on short-term bonds moves opposite from the capital stock, all else being constant. Since the capital stock would gradually *increase* under a consumption tax, relative to its level under an income tax, the real yields on short-term corporate and Treasury debt would gradually *decline* after tax reform, eventually stabilizing at about three-fourths their current levels.

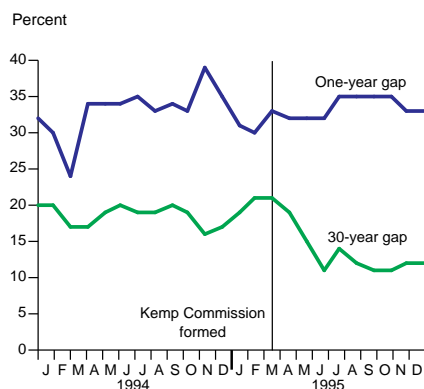
The time path of short-term municipal bond yields would be quite different. Municipal bonds currently have an advantage relative to corporate and Treasury bonds because they are tax-exempt. Under either a national sales tax or the Army flat tax, this advantage would disappear: all bonds would be treated the same. After the implementation of tax reform, the yield on municipal bonds would jump upward to match the yield on other bonds. Thereafter, the yields on all short-term bonds would move in tandem.

Table 1
Likely Effects of the Switch
To a Consumption Tax

	Near term	Long term
Investment	+	+
Capital stock	0	+
Wages and benefits	0	+
Consumption	-	+

“While there’s room for disagreement on exactly which options package is right, there can be little doubt that the consumption tax is an idea whose time has come.”

Chart 2
Treasury—Municipal Percentage Yield
Gaps: Behaving as Predicted



SOURCES: Board of Governors of the Federal Reserve System, Bloomberg and authors' calculations.

The current return on a 30-year bond is an average of the one-year returns expected over the next 30 years. Therefore, if people think that either a national sales tax or the Arney flat tax is coming, a gradual closing of the gap between long-term Treasury and long-term municipal bond yields should already be apparent. There should be no corresponding closure of the gap between short-term Treasury and short-term municipal bond yields until reform is imminent.

The behavior of municipal bond yields relative to Treasury bond yields suggests that traders began taking the possibility of comprehensive tax reform seriously following the appointment of Jack Kemp (R-New York) to chair a reform commission (*Chart 2*). At the long end of the maturity spectrum, recent months have seen the percentage gap between 30-year Treasury bond yields and 30-year municipal bond yields cut in half, from 20 percent to 10 percent. However, no change in tax regime is expected until after the 1996 elections: no shrinkage of the yield gap is yet apparent for bonds that mature before November 1996.

The Politics of Tax Reform: Winners and Losers. The vast majority of people would gain from the switch to a consumption tax. But the gains would not be distributed evenly, and—especially in the years imme-

diately following reform—some people would suffer net losses. Risky new businesses in high-growth, capital-intensive industries would be clear winners from tax reform. These firms would benefit from the more favorable treatment of equity finance and the increased flow of savings provided by a consumption tax. Holders of existing municipal bonds would be short-term losers under the national sales tax or Arney flat tax because these plans remove current tax preferences for municipal bonds. (The USA tax plan would remove the tax preference for new municipal bonds but retain it for existing bonds.) People who live in high-tax areas—like New England and the Great Lakes region—are also hurt by tax reform in the short run because they lose their ability to deduct state and local income and property taxes. Similarly, homeowners would likely find that the fall in long-term interest rates caused by tax reform would not, at first, fully offset the elimination of the mortgage interest and property tax deductions.

Conclusion

The choice between the current U.S. income tax and a consumption tax is like the choice a family makes when deciding whether to trade in its 5-year-old car for a new model in its first year of production. The new model has no track record. Its handling might take some getting used to, and buying it would mean pulling together a down payment. On the other hand, it has an engine that is more powerful, more efficient, and easier to repair and maintain. The performance of the older vehicle has been slowly deteriorating, and the car needs more and more repair. While there's room for disagreement on exactly which options package is right, there can be little doubt that the consumption tax is an idea whose time has come.

—Evan F. Koenig
Lori L. Taylor

the Southwest ECONOMY

Federal Reserve Bank of Dallas

Robert D. McTeer, Jr.
President and Chief Executive Officer

Tony J. Salvaggio
First Vice President and Chief Operating Officer

Harvey Rosenblum
Senior Vice President and Director of Research

W. Michael Cox
Vice President and Economic Advisor

Stephen P. A. Brown
Assistant Vice President and Senior Economist

Research Officers

John Duca
Robert W. Gilmer
William C. Gruben
Evan F. Koenig

Economists

Kenneth M. Emery
David M. Gould
Joseph H. Haslag
D'Ann M. Petersen
Keith R. Phillips
Stephen D. Prowse
Fiona D. Sigalla
Lori L. Taylor
Lucinda Vargas
Mark A. Wynne
Mine K. Yücel
Carlos E. Zarazaga

Research Associates

Professor Nathan S. Balke, Southern Methodist University; Professor Thomas B. Fomby, Southern Methodist University; Professor Kathy J. Hayes, Southern Methodist University; Professor Gregory W. Huffman, Southern Methodist University; Professor Finn E. Kydland, Carnegie Mellon University; Professor Roy J. Ruffin, University of Houston;

Executive Editor

Harvey Rosenblum

Editors

W. Michael Cox • Mine K. Yücel

Managing Editor

Rhonda Harris

Copy Editor

Monica Reeves

Graphic Design

Gene Autry • Laura J. Bell • Ellah K. Piña

The Southwest Economy is published six times annually by the Federal Reserve Bank of Dallas. The views expressed are those of the authors and should not be attributed to the Federal Reserve Bank of Dallas or the Federal Reserve System.

Articles may be reprinted on the condition that the source is credited and a copy is provided to the Research Department of the Federal Reserve Bank of Dallas.

The Southwest Economy is available free of charge by writing the Public Affairs Department, Federal Reserve Bank of Dallas, P.O. Box 655906, Dallas, TX 75265-5906, or by telephoning (214) 922-5257.

Beyond the Border

Exchange Rates, Capital Flows and Monetary Policy in a Changing World Economy

Does a country's exchange rate policy influence its economic prosperity? This and other issues were addressed during the Federal Reserve Bank of Dallas' September 14–15 conference, "Exchange Rates, Capital Flows and Monetary Policy in a Changing World Economy." An important focus of the conference was what countries should think and do about exchange rates. For example, a country can fix its exchange rate, as most industrial countries, including the United States, did under the Bretton Woods system for 25 years after World War II. The other extreme among foreign exchange choices is to let the rate float, as the United States has more or less done since 1972. A third option for countries is a policy somewhere in between that's aimed at controlling exchange rate movements within predefined limits.

Do Exchange Rates Make a Difference?

Some economists have argued that nominal exchange rates, those quoted in the daily newspapers, have few effects on the real economy. In the 1970s, economist Milton Friedman advocated floating nominal exchange rates instead of fixed rates. Friedman argued that floating rates would adjust to economic activity and let markets operate more efficiently. Friedman and others believed that only changes in real exchange rates—those adjusted for price changes in each country—would affect real economic activity.

Furthermore, economists have

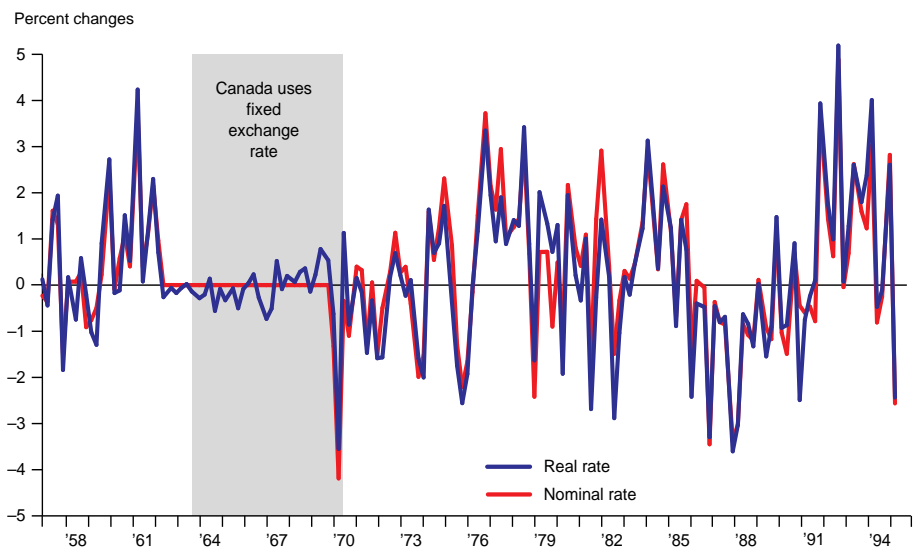
argued that changes in nominal exchange rates would not affect real exchange rates. Prices would adjust to offset changes in the nominal rate. Suppose that France had a small devaluation of the nominal exchange rate against the dollar, so that the dollar bought a few more francs after the devaluation. According to the argument, if a nominal devaluation occurred, France's domestic prices would increase to offset the exchange rate move. As an example, if the exchange rate went from 5 to 6 French francs per dollar, sellers might adjust by pushing up French wine prices from 25 francs to 30. A 25 franc bottle of wine with a 5 franc per dollar exchange rate is \$5. A 30 franc bottle of wine at a 6 franc per dollar exchange rate is still \$5, even though a dollar now buys 6 francs instead of 5. That is why a nominal devaluation would have no effect on the real, inflation-adjusted exchange rates, and there would be no real effects on the economy.

However, if a nominal devaluation occurred without an offsetting increase in France's prices, there would be real effects. A 20-percent

devaluation of the franc with no change in the franc price of French wine, for example, would mean French wine would be 20 percent cheaper in dollars. Americans would most likely buy more French wine and less California wine. That would be a real effect. This scenario more closely resembles how things really work.

The relationship between the U.S. dollar and the Canadian dollar illustrates how changes in nominal rates affect real rates. Chart 1 is a plot of the Canadian dollar/U.S. dollar nominal and real exchange rates during a period of fixed exchange rates—the late 1960s and very early 1970s—and during a period of floating rates—1972 to the present. If changes in the nominal exchange rate had no effect on the real exchange rate, the real rate on this chart would stay flat around zero, no matter how much the nominal rate changed. But that is not what happened. When Canada fixed its nominal exchange rate in the 1960s, real exchange rate volatility declined. But when the Canadians floated their dollar in 1972, real exchange rate volatility also rose. Thus, when the nominal exchange rate moved around a lot, so did the real rate. Clearly, nominal exchange rate changes can have real effects.

Chart 1
Canadian Dollar–U.S. Dollar Nominal and Real Exchange Rates



Beyond the Border...concluded

Floating Exchange Rates

Despite this finding, many conference speakers expressed support for floating exchange rate systems, citing several advantages. Speaker Michael Dooley, professor of economics at the University of California at Santa Cruz, argued that a fixed exchange rate regime gives short-term insurance for investors. By using a floating rate, these investors bear more investment risk. The result is less movement of the hot in-and-out money some analysts accuse of disrupting many developing economies.

Another advantage of floating rates is they are less likely to move so far out of line with economic fundamentals as to create sudden megadevaluations. For example, the Mexican peso's overvaluation and subsequent crash could have been avoided with a floating exchange rate. Moreover, it may be more difficult today to maintain an overvalued exchange rate with the large size of international capital movements and new innovations, such as derivatives. Conference speaker Peter Garber of Brown University showed how derivatives could render some standard tools for defending a currency, such as raising interest rates to attract new capital, completely ineffective in some cases.

Floating exchange rates also have their problems. Speaker Jeff Frankel of the University of California at Berkeley noted that floating exchange rates have tended to be very volatile, and their volatility may also discourage trade. Vittorio Corbo of the Catholic University of Chile observed that exchange rate volatility may hamper international investment because it makes it more risky. When investment slows, so does overall economic growth. Frankel also explained that exchange rate fluctuations may cause an exchange rate bubble. Bubbles develop when speculators, thinking that a move in a certain direction

might continue, bet on the trend no matter how far out of line with economic fundamentals it actually is. This progressively wider wedge between the exchange rate and economic fundamentals eventually gets corrected, with negative repercussions for financial markets and economic stability.

Fixed Exchange Rates

Heavily controlled exchange rates—those that are pegged at a constant rate, allowed to crawl at a preannounced rate or allowed to fluctuate within a band—received a lot of interest in the 1980s, as World Bank economist Sebastian Edwards pointed out. Many people thought that controlled rates could serve as an anchor that tethered domestic prices to international prices by targeting the exchange rate. The idea was that managed exchange rates would serve as part of a credible anti-inflation policy. Countries with pegged exchange rates, it was believed, would be less likely to dare to expand their money stocks at a faster rate than the countries to which their exchange rates were pegged. Doing so would mean that the exchange rate would have to be abandoned.¹

However, fixed exchange rates have their own their problems, as many conference participants pointed out. Fixed exchange rates, or even currency boards, are not as immutable as some might believe. The collapse of the European exchange rate mechanism and the Mexican peso are two examples. Also, Peter Garber argued that it is getting even harder for countries to defend a fixed rate from speculative attacks and bubbles. Sooner or later, these attacks always seem to come if the exchange rate does not match the economic fundamentals.

Finally, countries that use the exchange rate as a nominal anchor against inflation rarely reduce their inflation rates to the level of the country whose currency they're

pegged to. This can lead to a serious overvaluation, which is what happened in Mexico. Although exchange rate policy contributed to a drastic drop in Mexican inflation, it was not enough to match U.S. inflation. Because inflation in Mexico grew faster than the exchange rate, Mexican products became expensive relative to U.S. goods. Mexican imports rose and capital inflows fell. The result was a balance of payments crisis, an attack on the currency and a large, disruptive devaluation.

Conclusion

One consensus of the conference was that, despite valid circumstances for managing exchange rate movements, floating rates appear to be a more practical policy. The strongest case for fixed exchange rates could be made for very small and very open economies, such as Panama or Bermuda. But even in these cases, periodic exchange rate adjustment could be necessary.

Participants wholeheartedly rejected a return to the Bretton Woods system of fixed exchange rates. Also rejected was explicit monetary coordination between countries if it meant domestic concerns would take a back seat to international objectives. The consensus generally was that countries should look toward domestic stability as their objective, which would reduce long-run exchange rate volatility.

—Beverly Fox
David Gould
Bill Gruben

Note

¹ For small countries, Steve Hanke of Johns Hopkins University and Allan Meltzer of Carnegie Mellon University both endorsed something even stronger—a currency board. Steve Hanke argued that this currency arrangement would ultimately lead to more stable financial markets. For a more detailed analysis of currency boards, see Carlos Zarazaga, "Can Currency Boards Prevent Devaluations and Financial Meltdowns?" *Southwest Economy*, Issue 4, 1995.

Regional Update

The Eleventh District economy grew at a healthy pace in the fourth quarter of 1995. Fourth-quarter data showed that employment growth slowed in Louisiana, accelerated in New Mexico and remained quite strong in Texas. In early January, Beige Book respondents reported continued economic expansion but at a more moderate pace. Recent movements in leading economic indicators also suggest that the District economy is likely to grow at a slightly slower pace in 1996 than in 1995.

District nonfarm employment increased at a 3.8-percent annual rate in the fourth quarter, a healthy increase from the 2.8-percent annual average during the first nine months of 1995 but slower than the very strong 4.8-percent posted in 1994.

Employment growth was concentrated in the private sector, which grew at a 4.5-percent annual rate in the fourth quarter, up from the 2.8-percent annual rate of the first nine months of the year. In contrast, the volatile government sector grew at 0.7-percent annual rate in the fourth quarter, after posting a 2.8-percent growth rate in the first nine months of 1995.

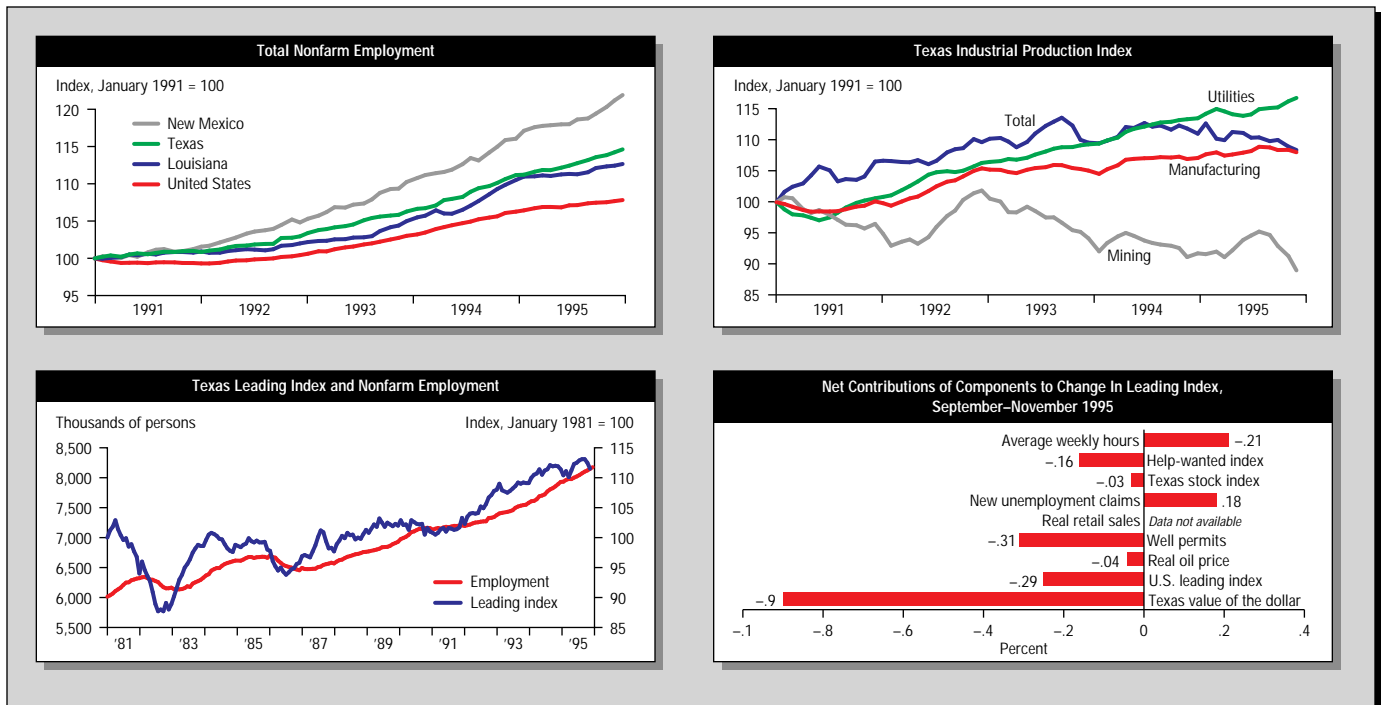
Fourth-quarter employment grew strongly in construction, trade, business, health and transportation industries. Trucking deregulation, which took effect in January 1995, likely contributed to the pickup in transportation industry jobs in Texas. District construction activity continued to increase at a healthy pace. Construction employment increased strongly

in the fourth quarter, jumping 12.2 percent. Recent gains in housing permits suggest continued strength in home building over the next several months.

Employment continued to decline in apparel and transportation equipment and posted anemic growth in finance and real estate. Texas industrial production declined in November due to declines in mining and utilities.

While prospects remain good for the Eleventh District, the January Beige Book suggests three trends that might dampen growth in 1996. First, contacts expressed concern about less stimulus from a slower growing national economy. Second, labor market tightness is reported to have recently begun to push up wages. Finally, an expected consolidation of retailers might slow employment growth in that sector as well as nonresidential construction.

—Keith R. Phillips



REGIONAL ECONOMIC INDICATORS

Texas Leading Index	Texas Employment							Total Nonfarm Employment		
	TUPI total	Mining	Construction	Manufacturing	Government	Private service-producing	Texas	Louisiana	New Mexico	
12/95	—	154.5	428.3	1,040.4	1,469.8	5,083.4	8,176.4	1,809.0	709.4	
11/95	111.5	119.2	154.5	423.4	1,036.9	1,467.9	8,148.7	1,805.4	705.2	
10/95	112.5	119.5	155.7	421.9	1,033.6	1,464.4	8,121.2	1,803.8	700.1	
9/95	113.1	119.5	155.9	417.7	1,033.1	1,469.0	8,101.6	1,800.3	694.9	
8/95	113.1	119.9	155.2	411.6	1,032.0	1,469.8	8,073.9	1,791.2	691.1	
7/95	112.9	120.0	155.6	409.3	1,029.7	1,461.9	8,044.2	1,786.8	690.3	
6/95	112.5	119.3	156.8	408.2	1,030.2	1,455.3	8,020.6	1,787.6	686.6	
5/95	112.3	119.1	156.9	407.0	1,029.5	1,446.7	8,001.0	1,786.5	686.5	
4/95	111.2	118.8	156.1	402.2	1,031.3	1,443.7	7,977.0	1,783.2	685.8	
3/95	110.1	118.7	156.8	405.8	1,032.0	1,441.4	7,979.1	1,784.4	685.3	
2/95	111.1	119.1	157.3	405.7	1,029.9	1,438.4	7,962.4	1,782.4	684.3	
1/95	110.4	118.9	157.6	401.7	1,026.6	1,433.4	7,933.7	1,781.8	681.5	

FURTHER INFORMATION ON THE DATA

For more information on employment data, see "Reassessing Texas Employment Growth" (*Southwest Economy*, July/August 1993). For more information on TIPI, see "The Texas Industrial Production Index" (Dallas Fed *Economic Review*, November 1989). For more information on the Texas Leading Index and its components, see "The Texas Index of Leading Indicators: A Revision and Further Evaluation" (Dallas Fed *Economic Review*, July 1990).

Online economic data and articles are available on the Dallas Fed's electronic bulletin board, Fed Flash (214) 922-5199 or (800) 333-1953.



Look for *Southwest Economy*
on the world wide web...

<http://www.dallasfed.org>

Southwest Economy and much of the data used to produce it are available on *FedDallas*, the Dallas Fed home page. This and other Dallas Fed publications are online in text and PDF formats, along with hundreds of other useful files, such as...

- Banking research and instructions for corporations wishing to file applications with Dallas Fed regulators.
- Texas economic data, including the Texas Industrial Production Index and Texas Index of Leading Indicators.
- Information about the Center for Latin American Economics.
- The Dallas Fed's exchange rate measure, Trade-Weighted Value of the Dollar.
- Links to other Federal Reserve sites and sites related to economics, finance and policy issues.
- Frequent updates and additions.

Best of all, *FedDallas* e:mail lets *Southwest Economy* readers comment on articles, critique the site and suggest future improvements. Stop by soon.

FEDERAL RESERVE BANK OF DALLAS
P.O. BOX 655906
DALLAS, TEXAS 75265-5906

BULK RATE
U.S. POSTAGE
PAID
DALLAS, TEXAS
PERMIT NO. 151